Supplementary Papers on Federal-Provincial Finance

1972 Ontario Budget

The Honourable W. Darcy McKeough, Treasurer of Ontario

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Presented by the Honourable W. Darcy McKeough,
Treasurer of Ontario
in the Legislative Assembly of Ontario, Tuesday, March 28, 1972

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Foreword

During the past year, the Government of Ontario has been involved in a particularly full schedule of discussions on intergovernmental fiscal and financial relations with the federal and other provincial governments. Altogether, there have been two meetings of First Ministers, three of Ministers of Finance, several of ministers concerned with specific federal-provincial programs, along with numerous preparatory meetings of officials. Among the important questions covered were constitutional reform, taxation reform and associated changes in intergovernmental financial arrangements, and the co-ordination of governmental policies in dealing with the problems of unemployment and economic growth.

This document contains three statements I made on behalf of the Government of Ontario at the most recent meeting of federal and provincial Ministers of Finance in Alberta, on January 31 to February 1, 1972. They have been reprinted in this convenient form to provide Members of the Legislative Assembly and the general public with information on some of the proposals the Government has made on the reform of federal-provincial fiscal and financial relations in Canada. In particular, the three statements in this document have been selected to provide fuller details on the main points covered briefly in the report on Federal-Provincial Relations in my 1972 Budget Statement. In addition the document contains a list of publications on federal-provincial fiscal relations, along with statements by the Prime Minister and myself on the subject over the past year.

The three statements in this document do not deal with all aspects of the questions they cover. Rather, they should be viewed as contributions to federal-provincial discussions which are of a continuing nature. In this sense, they should be studied along with other proposals made by the Government of Ontario in recent years.

The Ontario Government will give the highest priority to developing new fiscal arrangements which meet the dual objective of reinforcing the financial capacity of the provinces to meet their expenditure responsibilities while at the same time supporting the federal government's central position in the area of fiscal policy. The Ontario Government is committed to seeking practical solutions to the problems of intergovernmental finance which are consistent with the needs of all Canadians.

Hon. W. Darcy McKeough
Treasurer of Ontario
28 March, 1972.

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Tax Sharing

Introduction

Throughout the long process of tax reform, the Ontario Government has maintained consistently that reform of tax sharing is inseparable from reform of the income tax structure itself.[1] These two dimensions of tax reform are inevitably linked for one simple reason. Unless the revenues from the new income tax system are distributed fairly between the two levels of government, the whole purpose and impact of the tax reform exercise will be quickly negated. Inadequate revenue sharing will inevitably force the provinces to make successive increases in their income tax rates in the years ahead. This will increase total income tax levels, undermine improvements in equity and neutrality under the new tax structure, and wipe out any lasting benefits of tax reform to taxpayers themselves.

Over the past several years the federal government has insisted that no changes in tax sharing should be made or discussed until the new national income tax structure was developed. Though Ontario favoured a comprehensive approach to tax reform — embracing both reform of the tax structure and reform of tax sharing — we co-operated and concentrated our efforts on making a significant contribution towards the design of an improved income tax structure. Now that this new income tax structure is in force, however, it is vital that the federal government sit down with the provinces and work out an adequate tax sharing arrangement for the years ahead.

Inadequacy of Existing Tax Sharing

The inadequacy of existing tax sharing has been documented extensively over the past five years.[2] The federal government commands the predominant share of tax revenues, particularly in the high-growth income tax field, while the provincial-municipal level of government is responsible for the major expenditure programs and emerging public priorities. Thus, provincial-municipal governments have been chronically underfinanced in relation to their existing expenditure commitments, while the federal government has enjoyed surplus revenue potential in relation to its own-account expenditures and responsibilities. Projections of government revenues and expenditures undertaken by the Tax Structure Committee confirm this basic fiscal imbalance and point to an ever-widening gap in the distribution of taxing powers vis-à-vis spending responsibilities at the two levels of government.

The deficiency of existing tax sharing is clearly demonstrated by the appearance of provincial surtaxes in the personal income tax field. At the beginning of the current tax-sharing agreement in 1967-68, only two provinces levied personal income surtaxes and the weighted average rate for all provinces, at 28.37 per cent, closely matched the standard 28 per cent rate of federal abatement. The situation at the end of the current tax-sharing agreement stands in stark contrast. At present eight provinces levy personal income surtaxes and the weighted average provincial income tax rate is 30.04 per cent, or more than 2 points higher than the 28 per cent rate recognized by the federal government for tax sharing. This clearly shows that the provinces inevitably must have greater access to the personal income tax field. And the only way of providing this greater access without increasing total tax

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[1] Hon. Charles MacNaughton, *Ontario Proposals for Tax Reform in Canada* (Toronto: Department of Treasury and Economics, 1970), pp. 7-8; and, Hon. W. Darcy McKeough, *Ontario Budget 1971* (Toronto: Department of Treasury and Economics, 1971), pp. 7-8.

[2] See "Report of the Tax Structure Committe to the Federal-Provincial Conference: Projection of Government Revenues and Expenditures", October 28, 1966, and subsequent updatings.

levels is for the federal government to relinquish its surplus occupancy in the income tax field.

The failure to correct the tax-sharing imbalance over the past five years has resulted in two negative developments. First, provinces and municipalities have been forced to increase taxes regularly across the broad spectrum of direct and indirect taxes, thereby driving up total tax burdens in Canada to a very high level. Since a large part of this increased tax effort has necessarily been in regressive tax fields the problem of reforming the total tax structure and improving total tax incidence has been greatly compounded. Second, provinces have been driven to rely more and more on shared-cost financing from the federal government, thereby undermining accountability, cost control and normal priority-setting processes. All the while, the surplus taxing power in the hands of the federal government has been used to invent new programs and to lever additional provincial-municipal spending through the shared-cost mechanism. Indeed, the very existence of the present elaborate system of cost sharing demonstrates how far provincial-municipal taxing powers have fallen out of line with spending responsibilities. As we enter a new period of fiscal arrangements, therefore, it is imperative that the federal government recognize the past inadequacy of tax sharing and make room for an appropriate catch up in provincial tax occupancy.

Tax Sharing Under the New Income Tax System

At the same time that Ottawa is inviting the provinces to engage in independent taxing to meet deficiencies in their fiscal capacity, it has introduced a new income tax system which will restrict provincial ability to use this field. In fact, in the very process of reforming the national income tax structure the federal government has confronted the provinces with a *de facto* loss in income tax sharing. This deterioration in provincial tax sharing under the new income tax system is manifest in four ways.

1. The standard provincial share of revenue growth over time will be lower than under the old system.
2. The revenue yield from provincial surtaxes will grow more slowly than under the old system.
3. The provincial tax on dividend income will decline absolutely.
4. The provinces will not share in the long-run revenue gains which will result from the higher elasticity of the reformed income tax structure.

1. Reduced Provincial Share of Long-Run Revenue Growth

Under the new income tax system, the standard provincial share of total income tax revenues is locked in at 23.37 per cent.[3] Thus, as incomes rise over time the provincial share

[3] The arithmetic of the new tax sharing is as follows:

federal tax	100		
standard provincial tax	30.5	provincial share	$\frac{30.5}{130.5} = 23.37\%$
total tax	130.5		

of total revenue growth will remain constant at 23.37 per cent. Under the old system, by contrast, the provinces were entitled to a rising share of total revenue growth over time, ultimately reaching 28 per cent.

This revenue-sharing dimension under the old system resulted from the $6,000 taxable income ceiling on the special federal taxes (OAS and SDT) in which the provinces did not share. Below $6,000 taxable income the provincial share of total income tax revenues ranged from 18 to 22 per cent as shown below, while above the $6,000 plateau the provinces received 28 per cent of the total revenue growth. As a larger and larger proportion of taxpayers moved beyond the $6,000 taxable income level over time, therefore, the provincial share of total revenue growth would have gradually increased under the old system until it approached a full 28 per cent. The elimination of this built-in escalation in the provincial share of revenue growth over time constitutes a major tax sharing drawback of the new tax system, which no temporary revenue guarantee can replace.

Tax Sharing Under the Old Income Tax Rate Structure

Taxable Income	Fed. Tax Rate (1)	Prov. Tax Rate	Total Tax Rate	Provincial Share of Total Rate
$	%	%	%	%
Under 1,000	13.9	3.1	17	18
1,000	16.1	3.9	20	20
3,000	19.7	5.3	25	21
5,000	21.8	6.2	28	22
6,000	18.7	7.3	26	28
10,000	25.2	9.8	35	28
25,000	36.0	14.0	50	28
60,000	43.2	16.8	60	28

Note: 1. Federal rate equals 72% of the Basic Rate Structure plus 6% up to $6,000 for OAS and SDT and excludes the $20 tax reduction and temporary 3% surtax.

2. Reduced Revenue Growth From Provincial Surtaxes

Under the new income tax system, the incidence of provincial surtaxes (i.e., provincial rates in excess of 30.5 per cent) will shift downward and the revenue yield will tend to grow more slowly than under the old system. This results from the new method of calculating the surtaxes against the federal tax alone, rather than against the combined federal-provincial basic tax. The new federal tax rate exceeds the old combined rate under $6,000 taxable income but drops below it above $6,000 taxable income. As a result, provincial surtaxes will grip more heavily than before at the low end of the income scale and less heavily in the higher income ranges. As incomes rise over time, therefore, this reduced progressivity of the surtaxes will generate a slower growth in revenue yield than would have resulted under the old system.

Illustration of the Reduced Progressivity of the Provincial Surtaxes Under the New System

Taxable Income	Marginal Impact of a Surtax Equal to the Standard Provincial Tax Rate (1)	
	Old System	New System
$	%	%
1,000	3.9	5.8
3,000	5.3	6.4
5,000	6.2	7.0
6,000	7.3	7.0
10,000	9.8	8.2
25,000	14.0	11.9
60,000	16.8	14.3

Note: 1. That is, a surtax equal to 28% under the old system for a total provincial tax of 56%, and a surtax of 30.5% for a total provincial tax of 61% under the new system.

3. Reduction in Provincial Tax on Dividends

Under the new income tax system the provincial tax on dividend income will decline from its comparable level under the old system. This deterioration in the provincial tax position results from the combined impact of the new dividend tax credit and the new federal rate schedule. Thus, over the entire range of taxable income above $4,000 the provincial marginal yield on $100 of dividends drops below the comparable level under the old system. The federal marginal yield on dividends also declines in the lower and middle income range, but above $14,000 taxable income it rises dramatically. It is apparent, therefore, that the provinces will bear a disproportionate share of the revenue cost of the reformed dividend tax credit.

Federal-Provincial Sharing of the Change in Taxation of Dividend Income

Taxable Income Before $100 Dividend	Change in Marginal Tax on $100 of Dividends		
	Federal	Provincial	Total
$	$	$	$
4,000	−6.11(1)	−0.15	−6.26
6,000	−0.32	−0.46	−0.78
8,000	−0.64	−0.77	−1.41
10,000	−1.47	−1.35	−2.82
13,900	+0.26	−1.13	−0.87
15,000	+2.00	−0.90	+1.10
25,000	+3.73	−0.67	+3.06
40,000	+5.46	−0.45	+5.01
60,000	+7.20	−0.22	+6.98

Note: 1. Six dollars of the federal decline results from elimination of the special federal taxes (OAS, SDT) which formerly were levied on taxable income up to $6,000.

4. *Zero Provincial Share in Elasticity Gains*

The new personal income tax system is inherently more revenue productive than the old system. To quote the federal *Summary of 1971 Tax Reform Legislation:*

> As the new system matures, it will generate more revenue annually than would the existing system had it continued to operate under current rules and rates.[4]

Ontario's quantitative analysis of the national tax reforms also confirms this higher elasticity of the new personal income tax system. As a result, a stream of long-run revenue gains will be generated.[5] But this entire improvement in long-run revenue raising potential will accrue to the federal government and no share will accrue to the provinces.

The new personal income tax system will quickly generate less revenues to the provinces than they would have received under the old system. As shown below, the federal government's own estimates for the purpose of the revenue guarantee display very clearly this progressive erosion of the provincial revenue yield from 1972 to 1976. During the same five years, however, the new personal income tax system will produce huge revenue increases to the federal government which are to be turned back to taxpayers in the form of reductions in the lowest marginal rate of tax.

[4] Hon. E.J. Benson, *Summary of 1971 Tax Reform Legislation* (Ottawa: Department of Finance, June, 1970), p. 61.

[5] For an explanation of the inherent long-run revenue growth capacity of personal income tax systems see, Staff Paper, *Tax Reform and Revenue Growth to 1980, Ontario Studies in Tax Reform 4* (Toronto: Department of Treasury and Economics, March, 1971).

Estimated Change in Provincial Personal Income Tax Revenues Under the New Income Tax System

	All Provinces
	$ millions
1972	+31.8
1973	+24.4
1974	+ 0.9
1975	–12.4
1976	–34.2

What then will be the situation after 1976? The provinces will be forced to increase their tax rates merely to restore the revenue yield they could have expected under the old system. The federal government, by contrast, will have permanently improved its long-run revenue-raising potential. Thus, the long-run consequence of the tax reform process itself will be a further worsening of the already inadequate tax sharing between the two levels of government.

Independent Taxing is no Solution

Since 1966 the federal government response to the obvious need for reformed tax sharing has been to urge the provinces to independently raise their income tax rates. As has already been pointed out, eight provinces have already been driven to this stop-gap course of action. But this has not provided an intelligent solution to the underlying problem. It has merely meant that the total income tax burden has risen, interprovincial tax differences have widened and the basic incidence pattern has been distorted.

Under the new income tax system, independent provincial taxing is even less appropriate for two important reasons. First, unless income tax room is vacated by the federal government, independent provincial tax increases will lead to excessive total tax burdens and destroy the equity and neutrality advances of the reformed income tax structure. Second, the new income tax system imposes significant constraints on the provinces in terms of their real ability to secure greater income tax revenues.

As documented in the previous section, the increase in revenues from a given increase in provincial tax effort will be lower under the new system than under the old system. The provinces, in short, would have to take three steps forward in order to end up two steps ahead. It would be entirely perverse if the provinces were forced to increase their income tax rates merely to regain the revenue potential and the tax-sharing position they formerly enjoyed. Yet this is exactly what will happen and why it has been necessary for the federal government to offer the palliative of a 5-year revenue guarantee. A much more satisfactory and more permanent solution is required. In Ontario's view, what is required is nothing less than a basic reform in federal-provincial tax sharing.

Ontario Proposal for Reform of Tax Sharing

There are two main requirements for a sensible solution to the tax-sharing problem. First, it is necessary to recognize that federal-provincial financing has already moved substantially out of balance, and move to correct this existing deficiency. Second, it is imperative that the future growth in income tax revenues be divided fairly and reasonably between the two levels of government. In order to achieve an orderly process of federal-provincial adjustments and to consolidate the new national tax structure, the Ontario Government advances the following two-part strategy for reform of income tax sharing.

The initial step in reform would be to increase the standard provincial income tax recognized by the federal government up to the actual weighted average provincial tax rate in 1972-73 — that is, an increase from 30.5 per cent to 32.5 per cent. This would at least partially correct the past tax-sharing deficiency. The second stage of reform would be to increase this standard provincial tax rate by 1 point in 1973, by 3 points in 1974 and by a further 2 points in 1975 and 1976. In this way the standard provincial tax rate would reach 40.5 per cent in 1976. Offsetting this increase in standard provincial tax effort there would be a series of corresponding reductions in federal income tax. In each of the next five years, therefore, the total income tax burden would remain at 130.5 but the federal-provincial sharing ratio would gradually improve to 90/40.5 as shown below.

Proposed Timetable for Tax Sharing Reform

	Standard Provincial Tax Rate	Reduction in Federal Tax	Change in Tax Sharing Ratio
	%		
1972	32.5	100 — 2%	—
1973	33.5	100 — 3%	33.5/97
1974	36.5	100 — 6%	36.5/94
1975	38.5	100 — 8%	38.5/92
1976	40.5	100 — 10%	40.5/90

Since the federal government has already planned a 3 per cent tax cut for 1972, the initial tax sharing adjustment could reasonably be delayed until 1973. This would mean that the 3 per cent federal tax cut would be made permanent rather than temporary, and this permanent tax cut would rise to 6 per cent in 1974, to 8 per cent in 1975 and to 10 per cent in 1976. After these adjustments were completed in 1976 this revised tax sharing could be formalized by means of a new discounted federal rate structure and a new equivalent provincial tax rate. For 1977 and beyond, therefore, the federal income tax rate structure would be 10 per cent lower than the present federal rate structure while the new standard provincial income tax rate would be 45 per cent.[6]

[6] A 45 per cent provincial rate levied against a discounted federal tax of 90 is equivalent to a 40.5 per cent provincial rate levied against a federal tax of 100.

Conclusion

The time has come for fundamental reform of federal-provincial tax sharing. The provinces have waited patiently throughout the long process of tax structure reform and managed as best they could with inadequate income tax capacity. Now that the new income tax system is in place, the provinces are faced with a further deterioration in their revenue raising capacity. An immediate solution must be found. And it must be a sensible solution, one which corrects the past tax-sharing deficiency and redistributes future revenue growth fairly and reasonably between the two levels of government. The Ontario Government has advanced a two-part plan for achieving this overdue reform. An approach along the lines we have proposed would ensure a fairer division of the revenues from the new income tax system, contain total income tax burdens, reduce interprovincial tax differences and reinforce the equity and neutrality thrusts of the new income tax structure. Only with such a solution to tax sharing can we hope to maintain a truly national income tax system in Canada.

Appendix 1

Actual Provincial PIT Rates Versus the Standard Provincial PIT Rate Recognized in Tax Sharing

	1967–68					1972–73				
Prov.	Rate		Relative Weighting (1)			New Rate		Relative Weighting (1)		
	%		%			%		%		
Nfld.	28	x	0.99	=	.2772	36.0	x	1.06	=	.38160
P.E.I.	28	x	0.19	=	.0532	36.0	x	0.20	=	.07200
N.S.	28	x	2.15	=	.6020	38.5	x	2.39	=	.92015
N.B.	28	x	1.53	=	.4284	41.5	x	1.55	=	.64325
Que.	28	x	25.13	=	7.0364	34.0	x	23.90	=	8.12600
Ont.	28	x	44.32	=	12.4096	30.5	x	45.97	=	14.02085
Man.	33	x	3.98	=	1.3134	42.5	x	3.86	=	1.64050
Sask.	33	x	3.45	=	1.1385	37.0	x	2.39	=	.88430
Alta.	28	x	6.92	=	1.9376	36.0	x	7.18	=	2.58480
B.C.	28	x	11.34	=	3.1752	30.5	x	11.50	=	3.50750
			100.00%		28.3715			100.00%		32.78095

Weighted Average
Prov. Rate = 28.37%

Weighted Average
Prov. Rate = 32.78%

Standard Prov. Rate
for Tax Sharing = 28.00%

Standard Prov. Rate
for Tax Sharing = 30.50%

(1) Weighted according to the distribution of total personal income tax revenues among the ten provinces.

Appendix 2

Tax Sharing as a Division of the Personal Income Tax Rate Structure

Old System			New System		
Taxable Income	Fed. Tax Rate(1)	Prov. Tax. Rate (2)	Equivalent Taxable Income(3)	Fed. Tax Rate	Prov. Tax Rate(4)
$	%	%	$	%	%
1,001	16.1	3.9	1	17	5.2
2,001	18.2	4.8	1,001	19	5.8
3,001	19.7	5.3	2,001	20	6.1
4,001	21.8	6.2	3,001	21	6.4
5,001	21.8	6.2	4,001	21	6.4
6,001	18.7	7.3	5,001	23	7.0
7,001	18.7	7.3	6,001	23	7.0
8,001	21.6	8.4	7,001	25	7.6
9,001	21.6	8.4	8,001	25	7.6
10,001	25.2	9.8	9,001	27	8.2
12,001	28.8	11.2	11,001	31	9.5
15,001	32.4	12.6	14,001	35	10.7
25,001	36.0	14.0	24,001	39	11.9
40,001	39.6	15.4	39,001	43	13.1
61,001	43.2	16.8	60,001	47	14.3

Notes:

1. Federal tax rate equals 72 per cent of the basic rate structure plus 6 per cent of taxable income up to $6,000.
2. Provincial tax rate equals 28 per cent of the basic rate structure.
3. To allow for increased exemptions, etc., the equivalent taxable income under the new system is generously assumed to be $1,000 lower than under the old system.
4. Provincial tax rate equals 30.5 per cent of the federal tax rate.

II

Cost Sharing

Cost Sharing

Introduction

As I see it, cost sharing is an important item on our agenda for at least three reasons. First, the federal government has advanced proposals for changes in arrangements for the continuation of a number of major shared-cost programs. Second, the federal government as early as 1966 promoted the idea of provinces opting out and assuming full responsibility for established shared-cost programs, and offered the provinces fiscal equivalences to do so. Recently, the Ontario Government has announced its intention to exercise this option along the same lines as Quebec.[1] Opting out has now been fully discussed and the federal government has re-affirmed its agreement in principle. Consequently, there are no reasons why definite arrangements cannot now be made to allow any of the provinces wishing to do so to opt out immediately. Third, I believe that any objective observer, on reviewing the history of cost sharing, would be impressed by the lack of common sense in the plethora of programs and the urgent need for a complete overhaul and rationalization.

Background to Cost Sharing

The severely limited financial capacity of the provincial governments in the post-war period and the rapidly increasing need for spending in areas of provincial-municipal jurisdiction resulted in major changes in financial arrangements between the two levels of government. Among these was the introduction of new shared-cost programs. Some important shared-cost programs were of a non-continuing nature, as for instance the Trans-Canada Highway program. However, an increasing number of large new programs were of a continuing nature. Generally speaking, cost sharing became of ever-increasing importance as a means to assist the provinces to meet their expenditure responsibilities.

The vehicle of cost sharing was chosen without exception to assure the attainment throughout Canada of minimum national standards and portability of benefits or, in certain cases, more regionalized objectives. To this end provinces were obliged to meet certain conditions in each of these programs. The first major program of this nature was the hospital insurance program, introduced in 1958.

The post-war proliferation of conditional grant programs has left us with an uncomfortably large number of insignificant programs and a few very large ones. Together these programs involve over $2.5 billion per year in conditional transfers to all provinces. In addition, provinces receive over $500 million in unconditional adjustment payments for post-secondary education. These amounts reflect the degree to which provincial taxing powers are inadequate to finance their responsibilities. This trend is tantamount to changing the BNA Act by fiscal instead of constitutional means.

More importantly, cost sharing places over one third of provincial budgets in a special position outside the normal processes of priority setting and budgetary control. As such, shared-cost programs have often caused distortions in provincial planning and budgets by suddenly pre-empting the necessary matching funds or through inflexible commitments. In addition, cost sharing reduces the scope for provinces to maximize efficiencies in some of their largest spending areas because of the conditions and limitations under the programs.

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[1] See Hon. W. Darcy McKeough, *Ontario Budget 1971* (Toronto: Department of Treasury and Economics, 1971), pp. 8-9; Hon. W. Darcy McKeough, *The Reconstruction of Economic and Fiscal Policy in Canada* (Toronto: Department of Treasury and Economics, Nov., 1971), pp. 40-42; and Hon. William G. Davis, *Questions on Federal-Provincial Economic Co-operation* (Toronto: Department of the Premier, Nov., 1971), pp. 15-16.

Complexities of Current Cost Sharing

Although the total number of shared-cost programs is much larger, Ontario is directly involved in 52 shared-cost programs, of which over 40 are of a continuing nature. Thirteen Ontario operating departments are engaged in conditional grant programs, some administering as many as 12 individual programs. Among them they must deal with 13 federal departments and agencies, with some of Ontario's departments dealing with as many as four federal departments. Indeed, some individual programs involve a number of both federal and Ontario departments.

Within this complex administrative structure, the development of anomalies is virtually inevitable. Furthermore, some programs have built-in rigidities which add to the problems. For instance, the Ontario spending on juvenile offenders is not shareable under the Canada Assistance Plan — although similar programs in other provinces are shareable — because of certain rigidities in the wording of the Act and its departmental interpretations. Similarly, the Province's day nurseries program, presently shared under the Canada Assistance Plan, is being rationalized and expanded by Ontario and may be administered by the Department of Education in future. These changes embody an improvement in service level and greater efficiencies, yet the Province stands to lose its federal share for that part of the program which now qualifies under the Canada Assistance Plan. Obviously, a province which has opted out and assumed full responsibility would be able to introduce such improvements in service without financial penalty.

Again the costs of some types of nursing homes, such as homes for special care, are currently shared in a very complicated fashion involving the Ontario Departments of Health, Social and Family Services, as well as the federal Department of National Health and Welfare. The Province's plan to broaden coverage of insured services of health care to include these and other types of nursing homes is a major step towards improved services and greater cost efficiencies for our hospitals. Yet, this constructive policy creates new problems because of existing cost-sharing arrangements. One solution would be to broaden cost sharing under Medicare. The other solution would be to administer separately these special homes which now qualify for sharing. The latter solution would again create severe administrative drawbacks. These problems would not arise if the Province received its own taxing powers through opting out.

On a national basis, including bilateral shared-cost programs and excluding post-secondary education, the total number of shared-cost programs amounts to almost 70 programs. Yet, the vast majority are small and only three programs dominate the total. The majority of programs do not involve national standards and have limited regional or local objectives. For all provinces combined, hospital insurance, medicare and the Canada Assistance Plan account for 80 per cent of total shared-cost financing. In Ontario, federal sharing in these three programs accounts for over 85 per cent of the total. Almost 40 of the 70 programs are each worth less than \$1 million to all provinces combined. For Ontario some 22 programs receive less than \$250,000 each. Naturally, the complexities and administrative burden vary from program to program, but it is readily apparent that there must be more efficient ways to arrange the financing of established programs during the seventies. Similarly, it must be possible to do without all the administrative formalities involved in the many programs that are not national in scope.

The Case for Opting Out

Because of the long period of time that most conditional grant programs have been in existence, the basic objectives of these programs have not only been met but are well entrenched. For some of the major programs, such as hospital insurance and the Canada Assistance Plan, the federal government recognized this as early as 1966 when it made proposals towards provincial assumption of full responsibility in exchange for additional tax sharing. This original federal plan for opting out was renewed with some minor modifications, but was withdrawn subsequently.

Only Quebec accepted the federal proposals in 1966; the other provinces obviously required more time before electing to opt out and move towards full responsibility. The Ontario Government is now clearly convinced of the need to assume full provincial responsibility in the major provincial spending areas and has stated its strong preference for opting out on a number of occasions. In my statement to the last meeting of Ministers of Finance, I detailed the advantages to both levels of government from such a restructuring of current intergovernmental financial arrangements.

- It would eliminate many anomalies.
- It would enhance accountability and flexibility.
- It would obviate the need for excessive administrative and bureaucratic machinery at both levels of government
- It would promote efficiency and greatly simplify intergovernmental finance.
- It would avoid periodic intergovernmental arguments about individual programs and items.

Against the background of a multiplicity of joint programs and sharing formulas as well as myriad departmental connections between our two levels of government, I see no other common sense solution than to use our combined experience in determining the fairest and shortest route towards full provincial responsibility. As I have said before, Ontario prefers to accept its equivalence in the form of tax points. This can be done without any disadvantage to other provinces, as demonstrated by the case of Quebec.

The actual determination of fiscal equivalence should not be difficult. Presumably this can be done for other provinces on the same basis that Ottawa has determined Quebec's fiscal equivalences under the new income tax system. All governments have had extensive cost experience, particularly in the established continuing programs. The experience since 1966 should prove valuable in providing a more accurate assessment of an appropriate equivalence.

Health, Education and Welfare

In the context of my preceding comments, it will be clear to you that I can only look upon the various federal proposals for alternative arrangements in the health insurance field as inadequate steps in the right direction. They contain an element of recognition of the need for a restructuring of the health services delivery system. On this point, Ontario has repeatedly requested consideration of sharing the cost of nursing homes. The new proposals also move towards a degree of unconditionalization and forced cost control. I believe that,

under adequate opting-out arrangements, the same objectives could be reached with less administrative overhead and reduced financial penalty for the provinces.

The Canada Assistance Plan should also be considered for opting out. This plan is characterized by a cumbersome administrative overhead, uneven coverage in the country, intergovernmental disputes on eligible expenditures, and generally a great number of unnecessary complexities. It would be clearly to the advantage of the welfare delivery system if provinces and their local governments and agencies could assume full responsibility for this spending area. The Ontario Government is confident that greater freedom of action in this area would facilitate the adoption of a more rational and effective system of income support for our least fortunate citizens.

The whole question of the future of the post-secondary education agreement is, in my opinion, somewhat of a case by itself. As I see it, the federal government entered into this particular agreement in recognition of the provinces' financial plight in the face of escalating pressures from post-secondary education. This agreement, therefore, became in a real sense an unusual form of additional tax sharing. The federal government must have assumed that four points of personal income tax and one point of corporation income tax would meet the needs of the high-yield provinces, while other provinces might require adjustment payments to gain similar benefits. Obviously, therefore, it appears that the original federal assumption was too optimistic and the required tax equivalence for half of the eligible costs should have been put higher. Here, again, experience should be our guide in determining the additional tax points required to meet roughly half of the eligible expenditures in the high-yield provinces. Any additional adjustment payments that may still be required could be established in a similar way and escalated at an agreed rate. Once a new arrangement along these lines has been introduced it should be possible to discontinue the formal program and all its unnecessary administrative machinery. The financial position of both levels of government would be neither better nor worse than under current arrangements.

Conclusion

The Ontario Government acknowledges the important contribution of shared-cost programs in past years. They have resulted in a Trans-Canada Highway; they have provided an elaborate system of technical and vocational schools; they have facilitated the construction of hospitals; and, they have established high and comparable standards of services throughout Canada in hospital care, welfare and medical care. All this was made possible with federal funds and equal or larger provincial and municipal funds. At times these programs caused difficult changes in provincial and municipal priorities, but by and large they were a positive factor in achieving worthwhile objectives.

However, the Ontario Government feels that the very complicated and cumbersome structure of shared-cost programs now in existence is no longer warranted to assure the maintenance of the standards and objectives already reached. In fact, it is becoming obvious that the very existence of some major formula-oriented programs is an impediment to the further improvement of the services involved and the achievement of greater cost efficiencies.

Therefore, the Ontario Government is convinced that the time has come to completely reform the financing arrangements for federal-provincial shared-cost programs. Ontario has already proposed the discontinuation of all such current arrangements and today repeats its

own strong preference for opting out in exchange for equivalence through additional tax room. This is already the arrangement with Quebec for a large part of cost sharing and Ontario would like to accept the same method of financing for all current shared-cost programs.

The Ontario Government can see no meaningful disadvantages in such a revised system, and, on the contrary, is impressed with the significant advantages inherent in this new system.

Appendix

A Profile of Federal-Provincial Cost Sharing in Ontario

The purpose of this appendix is to indicate the complexity of cost sharing arrangements between the Province of Ontario and the federal government. In approaching this question, it should be emphasized that the term "shared cost" is very general, describing arrangements which vary in both scope and structure. Federal-provincial agreements range from those where the federal government "buys" a service from the province, paying 100 per cent of the costs incurred, to those where certain eligible costs of a provincial program are shared in a pre-determined proportion by the federal government. In some cases, federal control has consisted primarily of a year-end audit of provincial expenditures. In other instances, there has been close control of the nature and expansion of the service provided. Between these two extremes lie several different types of program structures which are described below.

The Province of Ontario was involved in 52 shared-cost agreements with the federal government in 1970-71. In terms of their financial magnitude, these formal and informal arrangements involved a direct provincial financial commitment of about $2.0 billion in 1970-71. Federal reimbursements or loans covered $1.0 billion of provincial expenditures. Of the 52 programs, over half had expenditures of under $1.0 million dollars. The smallest two involved a $250 claim for inspection of Indian schools by Provincial Area Superintendents and a claim of $563 for snow level measurements pursuant to the Weather Observation Agreement. There were five joint programs which had federal sharing of over $100 million: Medicare, Post-Secondary Education Adjustments, Hospital Insurance, the Canada Assistance Plan and Public Housing Projects. In many of the smaller programs, it was apparent that the cost to the province of administering and making claims alone exceeded the amount of federal reimbursement for projects undertaken. Furthermore, no interest payments were made to the Province for federal delays in the reimbursements of claims arising from prior provincial expenditures. In fact, it was in the largest programs that claims remained outstanding — occasionally for several years (e.g., Adult Occupational Training, $12 million; Public Housing, $7 million; and Post-Secondary Education, $3 million).

There are a great variety of administrative arrangements pertaining to these agreements. Some operate with a minimum of intergovernmental consultation apart from a year-end federal audit. These are usually agreements which are either small in cost or open-ended — such as various resource programs and Medicare. Others involve frequent federal-provincial meetings, either in Ottawa or with local federal offices throughout the province to establish the scope and mix of programs. This has been the case with ARDA projects, Adult Occupational Training and Pùblic Housing (CMHC). Some agreements involve not only the transfer of funds but also the exchange of personnel, equipment or offices.

There is no one uniform pattern of sharing costs. Thirty-five of all the agreements, involving 91 per cent of all the funds, share costs on a proportionate basis with the federal share set at between 37.5 per cent and 100 per cent. Under the remaining agreements, federal money is received either on the basis of a formula related to case load, mileage, category or acreage, or on the basis of a flat, predetermined grant. Of the federal reimbursements, 18 per cent are in the form of loans which require repayment of interest and principal annually over fifty years. Two large agreements — Medicare and Hospital Insurance — involve sharing based upon national average per capita costs, thereby building in a implicit equalization factor for lower-cost provinces.

Agreements vary in duration. The shortest agreements — such as Rural Employment on Crown Land Forests and Fisheries Industrial Development — apply only to several months of the year. A few others are renewable annually or last a definite number of years. The various programs under ARDA fall into these categories. Almost all the remaining agreements have no specified termination date but only a very few, such as Hospital Insurance and the Canada Assistance Plan, have any formal regulation to prevent an abrupt termination by either party. Thus in some agreements where there is no formal provision for termination or alteration of cost sharing, the Province has experienced arbitrary federal changes, as in the Railway Grade Crossing Fund, Adult Occupational Training and Urban Renewal. It should also be noted that a number of informal arrangements pertaining to Indians have been made between the provincial departments and the federal Department of Indian Affairs and Northern Resources. The sums involved do not exceed $15 million although the arrangements manifest frequently the same problems as formal shared-cost agreements.

Ontario's involvement in cost-sharing arrangements with the federal government in 1970-71 can be classified in the following ways:

1. *Number and Magnitude:*

- Ontario had 52 formal and informal cost-sharing agreements with the federal government (excluding post-secondary education).
- in 1970-71 they involved a gross expenditure of $2 billion.
- federal reimbursements in the form of grants or loans amounted to $1 billion excluding post-secondary education adjustment payments.
- program expenditure involved total costs ranging from $250 to $785,000,000.
- half of all the shared-cost programs involved total expenditures of less than a million dollars each and accounted for only 1% of all federal reimbursements to Ontario.
- three programs in 1970-71 accounted for 85% of all reimbursements.
- federal transfers to assist provincial expenditures on post-secondary education are a case of tax sharing rather than cost sharing and they have been accordingly excluded from this study. The federal government will reimburse a province for 50 per cent of approved expenditures in this field by means of equalized tax abatements (4 per cent of basic individual income tax and 1 per cent of corporation income tax), plus a further cash adjustment if required.

2. *Means of Sharing*

- 82% of all federal programs involved grants; the remainder were repayable loans (usually over 30-50 years).
- 91% of these grants were made as a proportion of provincial costs.
- the remainder were either flat grants or based on formulae related to case load, mileage or acreage.
- in 7 of the shared-cost programs the federal government has imposed a ceiling on its share.

3. Duration

- the shortest programs last a year or less and are renewed annually; 7 are of this nature; 4 other terminating programs probably will be renewed.
- 30 have no termination date specified.
- the following 11 agreements have annual expenditures within a definite period of years and are terminating on those dates:

  Agricultural and Rural Development Agreement — until 1975

  Dams, Reservoirs and Channel Improvements — until 1975

  Health Resources Fund — until 1980

  National Health Grants — until 1972-73

  Geodetic Field Survey — until 1972

  Urban Renewal — until 1974

  Unemployment Assistance — phasing out

  Blind Persons Assistance — phasing out

  Disabled Persons Assistance — phasing out

  Queensway Agreement — final claims

  Fisheries Industrial Development — until 1972

- only the following 9 agreements have any provision to prevent abrupt unilateral cancellation by either party:

  Safety Inspection Services Agreement — 6 months notice

  Resources Development — 12 months notice

  Fires on Indian Reserves — prior to new fiscal year

  Language Textbook Agreement — 6 months notice

  Indian Welfare Services — 6 months notice

  Canada Assistance Plan — 12 months notice

  Rehabilitation Services Agreement — 6 months notice

  Hospital Insurance — 5 years notice

  Indian Community Development Programs — 1 year notice

4. *Administrative Aspects*

- disagreement between the federal and Ontario governments over the eligibility of certain costs for sharing have delayed reimbursements in the following programs:

  Adult Occupational Training — $12 million

  Post-Secondary Education — $3 million

  Low-income Rent Subsidies — $3 million

  Hospital Insurance — $15 million

III

Increased Provincial Tax Sharing and the Effectiveness of Federal Fiscal Policy

Increased Provincial Tax Sharing and the Effectiveness of Federal Fiscal Policy

In two other statements to this meeting of federal and provincial Ministers of Finance I have argued that provincial occupancy of the high-growth personal income tax field should be increased in order first, to allow provinces to opt out of the major shared-cost programs, and, second, to secure a better basic balance between provincial expenditure responsibilities and financial capacity. It has been suggested, however, that such an increase in provincial occupancy of the income tax field might run the danger of reducing the federal government's ability to use the personal income tax as a fiscal policy instrument for economic stabilization. While the limits to provincial occupancy in these terms have never been defined, there has been a suggestion that a 50-50 split of the income tax field is in some way appropriate.

The idea of some ultimate limit to the provincial share of the personal income tax field is obviously of critical importance to the whole question of intergovernmental finance. For example, if the federal government is not prepared to reduce its occupancy in favour of the provinces for this reason, what are the implications of the provinces raising their rates in the manner invited by the federal government? Both increased federal abatements and increased independent provincial tax efforts would have the same effect; that is, to increase the provinces' share of the income tax field and their potential economic leverage. Basically, however, the Ontario Government does not believe that a redivision of income tax revenues of the order needed to redress the existing imbalance in federal-provincial tax sharing and to refinance shared-cost programs would jeopardize the effectiveness of federal fiscal policy.

For this reason, I shall table for consideration by my federal and provincial colleagues copies of an earlier staff paper which contains an extensive examination of the occupancy of the personal income tax field required by the federal government. Basically, required federal occupancy of the field is made up of two components. The first is the occupancy needed to allow it to finance its own-account expenditure requirement, including equalization transfers to the provinces; the second is the occupancy needed to vary its income tax revenues for economic stabilization purposes. Without repeating our arguments in detail, let me say that federal occupancy should be determined by the larger of these two components. That is, if the federal government requires, say, 40 per cent of the total income tax field, along with its other taxes, to meet its expenditure requirements, this occupancy will automatically give it ample ability to use the tax for fiscal policy purposes.

The proposals for tax sharing and opting out advanced by the Ontario Government would involve a transfer of federal tax room to the provinces in the order of 29 per cent of the total income tax field — 8 per cent for improved tax sharing and perhaps 21 per cent as the fiscal equivalence for shared-cost programs. Deducting this total tax transfer from the present federal occupancy in the income tax field of 77 per cent would leave a federal occupancy of about 48 per cent and a provincial tax share of about 52 per cent.[1] Thus Ontario's proposed reforms in tax sharing would not impair the basic long-run capacity of the federal government to finance its expenditure responsibilities. And this same 48 per cent

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[1] The arithmetic of such a change in tax sharing would be as follows:

federal tax	61.5		
provincial tax	68.0	provincial share	$\frac{68.0}{130.5} = 52\%$
total tax	130.5		

federal occupancy would amply meet the needs of economic stabilization since the maximum change in income taxation that has been used historically has been 10 per cent.

As I said, I wish to table this paper today for consideration by the other ministers in the hope that it will provide a useful basis for clarifying the scope for an orderly redivision of the income tax field. I shall, of course, be pleased to answer any initial questions you may have at this point. The staff paper I am tabling is titled, "Alternative Methods of Transferring Federal Tax Revenues to the Provinces." This paper was presented originally to the Continuing Committee on Economic and Fiscal Matters as long ago as September, 1966, but more recently it was reprinted in a set of staff papers.[2]

[2] Staff Papers, *Intergovernmental Policy Co-ordination and Finance* (Toronto: Department of Treasury and Economics, 1970).

Appendix

Recent Ontario Government Publications and Statements on Federal-Provincial Fiscal Relations

PUBLICATIONS

A. *Tax Reform*

Hon. Charles MacNaughton	"The Reform of Taxation and Government Structure in Ontario", *Ontario Budget 1969,* Budget Paper B (Toronto: Department of Treasury and Economics, 1969).
———	*Ontario Proposals for Tax Reform in Canada* (Toronto: Department of Treasury and Economics, 1970).
———	*Tax Reform and Small Business* (Toronto: Department of Treasury and Economics, 1970).
Hon. W. Darcy McKeough	*Taxation of Corporations and Shareholders* (Toronto: Department of Treasury and Economics, 1971).
Staff Paper 1	*Analysis of the Federal Tax Reform Proposals* (Toronto: Department of Treasury and Economics, 1970).
2	*Effects of Ontario's Personal Income Tax Proposals* (Toronto: Department of Treasury and Economics, 1970).
3	*Technical Study on Tax Reform and Small Business* (Toronto: Department of Treasury and Economics, 1970).
4	*Tax Reform and Revenue Growth to 1980* (Toronto: Department of Treasury and Economics, 1971).
5	*Technical Study on Integration* (Toronto: Department of Treasury and Economics, 1971).
Hon. W. Darcy McKeough	"Ontario's Property Tax Credit Plan", *Ontario Budget 1972,* Budget Paper B (Toronto: Department of Treasury and Economics, 1972).

B. *Fiscal Policy Co-ordination*

Hon. Charles MacNaughton	"The Public Sector and Economic Policy", *Ontario Budget 1970,* Budget Paper A (Toronto: Department of Treasury and Economics, 1970).
———	"The Structure of Public Finance in Ontario", *Ontario Budget 1970,* Budget Paper B (Toronto: Department of Treasury and Economics, 1970).
Hon. William G. Davis	*Questions on Federal-Provincial Economic Co-operation,* Statement to the Meeting of First Ministers, Ottawa, November 15-16, 1971.
Hon. W. Darcy McKeough	"New Directions in Economic Policy Management in Canada", *Ontario Budget 1971,* Budget Paper A (Toronto: Department of Treasury and Economics, 1971).

——— "Provincial-Municipal Reform: a Progress Report", *Ontario Budget 1971*, Budget Paper B (Toronto: Department of Treasury and Economics, 1971).

——— *The Reconstruction of Economic and Fiscal Policy Co-ordination in Canada*, Statement to the Meeting of the Ministers of Finance, Ottawa, November 1-2, 1971.

——— "Fiscal Policy Management in Ontario", *Ontario Budget 1972*, Budget Paper A (Toronto : Ministry of Treasury, Economics and Intergovernmental Affairs, 1972).

Staff Papers — *Intergovernmental Policy Co-ordination and Finance* (Toronto: Department of Treasury and Economics, 1970).

C. *Constitutional Reform*

Ontario Advisory Committee on Confederation — *The Confederation Challenge*, Volumes 1 and 2 (Toronto: Queen's Printer, 1967, 1970).

MINISTERIAL STATEMENTS

Hon. William G. Davis — "The Constitutional Review in Perspective", Statement to the Constitutional Conference, Victoria, B.C., June 14, 1971.

——— "The Future of the Constitutional Review", Statement to the Constitutional Conference, Victoria, B.C., June 15, 1971.

——— "Report on the Constitutional Conference", Statement in the Legislative Assembly, Queen's Park, Toronto, June 21, 1971.

——— "Tri-Level Consultations", Statement to the Conference of First Ministers, Ottawa, November 15-17, 1971.

——— "An Expanded Role for the Secretariat of the Constitutional Conference", Statement to the Meeting of First Ministers, Ottawa, November 15-16, 1971.

——— "The Ontario Government's Plan for Economic Stimulation", Statement in the Legislative Assembly, Queen's Park, Toronto, October 8, 1971.

——— "An Economic Strategy for Ontario", Queen's Park, Toronto, October 14, 1971.

——— "Statement Concerning the Federal Economic Measures Announced on October 14th", Queen's Park, Toronto, October 15, 1971.

——— "The Ontario Government's Position Regarding Federal-Provincial Discussions on the Economic Situation", Statement to the Meeting of First Ministers, Ottawa, November 15-16, 1971.

Hon. W. Darcy McKeough	"The Federal Budget and Tax Changes", Statement in the Legislative Assembly, Queen's Park, Toronto, June 21, 1971.
———	"The Federal Tax Reform", Statement to the Meeting of the Ministers of Finance, Ottawa, July 12-13, 1971.
———	"The Preliminary Estimation of the Marginal Impact on Increased Earnings of the Three Federal Reform Programs—Personal Income Tax, Unemployment Insurance Programs and Family Income Security Plan", Statement to the Meeting of the Ministers of Finance, Ottawa, July 12-13, 1971.
———	"Federal Proposal for a Personal Income Tax Revenue Guarantee", Statement to the Meeting of the Ministers of Finance, Ottawa, November 1-2, 1971.
———	"Seasonal Employment Programs", Statement to the Meeting of the Ministers of Finance, Jasper, Alberta, January 31-February 1, 1972.
———	"The Development of Co-ordinated Long-Range Economic Policies", Statement to the Meeting of the Ministers of Finance, Jasper, Alberta, January 31-February 1, 1972.
———	"Tax Sharing", Statement to the Meeting of the Ministers of Finance, Jasper, Alberta, January 31-February 1, 1972.
———	"Cost Sharing", Statement to the Meeting of the Ministers of Finance, Jasper, Alberta, January 31-February 1, 1972.
———	"Increased Provincial Tax Sharing and the Effectiveness of Federal Fiscal Policy", Statement to the Meeting of the Ministers of Finance, Jasper, Alberta, January 31-February 1, 1972.

Ontario